

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Lempert Analyst: Roger Lackey Bill Number: AB 152
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 01-15-99

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Net Operating Loss Deduction Carryover/Losses On Or After 1/1/2000/Allowed For Entire Loss & For 20 Years/No Carry-backs Allowed

SUMMARY

This bill would allow 100% of a net operating loss (NOL) to be carried forward for 20 years.

EFFECTIVE DATE

This bill specifies that it would be a tax levy, operative for taxable or income years beginning on or after January 1, 2000, and would apply to net operating losses attributable to any taxable or income year beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 1994 (97/98); AB 34, AB 2407, SB 45 (93/94)

SPECIFIC FINDINGS

State law conforms, with certain significant modifications described below, to the federal NOL provisions. Generally, an NOL results when a taxpayer's business expenses exceed income in a particular year, thereby resulting in an "operating loss" for that year which is carried forward (or back) as a "net operating loss." For **federal** purposes, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years. **California** modifies the federal NOL rules to prohibit carry-back of the NOL deduction and to specify that generally only 50% of the NOL can be carried forward as a deduction for a period of five years.

State law contains special NOL provisions for the first three years a taxpayer operates a "new business." These taxpayers are allowed to carry forward 100% of the NOL incurred in each of the first three years of the new business. For any the taxpayer's total NOL that exceeds the net loss from the new business, 50% of that additional amount is carried forward as an NOL to future years. The NOL from the first year of a "new business" may be carried forward eight years, the NOL from the second year of such business may be carried forward seven years, and the NOL from the third year of such business may be carried forward six years. All net operating losses incurred after the first three years of business are no longer treated as a "new business" NOL and can only be carried forward for a maximum of five years at 50% of the total loss.

Board Position:

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Department Director

Date

Gerald Goldberg

2/19/99

Also, **state law** contains special NOL provisions for a taxpayer that operates an "eligible small business" in any taxable or income year. An eligible small business is defined as any trade or business that has gross receipts, less returns and allowances, of less than \$1 million during the taxable year. These taxpayers are allowed to carry forward to each of the five taxable years following the year of the loss, 100% of the eligible small business NOL. For any portion of the taxpayer's total net loss that exceeds the eligible small business loss, 50% of that amount may be carried forward as a NOL to future years. In addition, special ordering rules specify what happens if a taxpayer has both an eligible small business loss and a new business loss, or if a taxpayer has an eligible small business loss, a new business loss, and a loss subject to the general 50% carry-forward limitation.

Existing state law also contains special NOL provisions for qualified taxpayers who operate businesses within an enterprise zone, a local agency military base recovery area (LAMBRA), or a targeted tax area (TTA). These qualified taxpayers are allowed to carry forward 100% of their NOL for 15 taxable or income years, but may only use those carryovers to offset future income attributable to business activity in the area or zone.

California law allows special carry forward treatment for losses incurred as result of a disaster declared by the President. That is, 100% of the excess disaster loss may be carried over for up to five taxable years, and if any of the excess loss remains after the five-year period, 50% of the remaining excess loss may be carried over for up to 10 additional years.

The following table recaps the various California NOL provisions:

Type of NOL	NOL % Allowed to be Carried Over	Carryover Period
General NOL	50%	5 Years
New Business Year 1	100%	8 Years
Year 2	100%	7 Years
Year 3	100%	6 Years
Eligible Small Business	100%	5 Years
Specified Disaster Loss	100%	5 Years
	50%	10 Years
LAMBRA, TTA & EZ	100%	15 Years

In the case of corporations doing business both within and without this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs (Section 25108) provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned income (or loss) and its allocated income (or loss).

This bill would allow all taxpayers to carry forward 100% of the NOL to each of the 20 taxable years following the year of the loss.

This bill specifies that it applies only to NOLs attributable to any taxable or income year beginning on or after January 1, 2000.

Policy Considerations

Enterprise zones, LAMBRAs, and TTAs were primarily created to encourage development in economically disadvantaged areas. By eliminating the more favorable NOL provisions for these areas and substituting rules which place all taxpayers on an equal footing with respect to the treatment of NOLs, this bill eliminates one of the incentives for businesses to locate in these depressed areas. However, those losses may be used only to offset zone income.

The applicable apportionment rule governing NOLs (Section 25108) provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned income (or loss) and its allocated income (or loss). However, this bill would provide that a taxpayer would receive 100% of its NOL without regard to where the operating loss was incurred.

This bill would benefit all taxpayers by reducing the complexity of calculating and determining the length of a NOL carryover.

Implementation Considerations

As written, this bill is unclear and may be confusing to taxpayers regarding the treatment of net operating losses that were incurred prior to January 1, 2000. As a result, Amendments 1 and 2 are provided to effectuate the author's intent and clarify that the provisions of this bill would only apply to net operating losses attributable to a taxable or income year beginning on or after January 1, 2000.

Implementing this bill would not significantly impact the department's programs and operations.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses from this bill are estimated to be:

Operating Losses Beginning on or after January 1, 2000 Impact of Additional NOL Deductions					
	2000-1	2001-2	2002-3	2003-4	2004-5
Bank & Corporation Tax	(\$5)	(\$34)	(\$77)	(\$115)	(\$137)
Personal Income Tax	(\$2)	(\$8)	(\$18)	(\$28)	(\$34)
Total	(\$7)	(\$43)	(\$95)	(\$144)	(\$171)

Any changes in employment, personal income, or gross state product that may result from this measure are not considered.

Revenue Estimate Discussion

Revenue losses under the Personal Income and Bank & Corporation Tax laws depend on the amount of positive adjusted gross/state net income that is available for deducting additional operating losses.

Estimates are based on actual NOL deductions claimed for the 1997 taxable/income year, adjusted to reflect 100% NOL carryovers for operating losses. These estimates allow for the limited availability of 100% NOL deductions under current law.

BOARD POSITION

Pending.

Analyst Roger Lackey
Telephone # 845-3627
Attorney Doug Bramhall

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 152
As Introduced January 15, 1999

AMENDMENT 1

On page 8, line 32, ~~strikeout~~ lines 20 through 33 and insert:

(1) For taxable years beginning on or after January 1, 2000, the deduction provided by Section 172 of the Internal Revenue Code, relating to a net operating loss deduction, shall apply as follows:

- (1) For net operating losses attributable to an operating loss incurred in a taxable year beginning before January 1, 2000, the modifications referred to in subdivisions (a) through (k) shall apply.
- (2) For net operating losses attributable to an operating loss incurred in a taxable year beginning on or after January 1, 2000, only the modification referred to in subdivision (c) shall apply.

AMENDMENT 2

On page 15, ~~strikeout~~ lines 30 through page 16, line 4 and insert:

(m) For taxable years beginning on or after January 1, 2000, the deduction provided by Section 172 of the Internal Revenue Code, relating to a net operating loss deduction, shall apply as follows:

- (1) For net operating losses attributable to an operating loss incurred in a taxable year beginning before January 1, 2000, the modifications referred to in subdivisions (a) through (l) shall apply.
- (2) For net operating losses attributable to an operating loss incurred in a taxable year beginning on or after January 1, 2000, only the modification referred to in subdivision (d) shall apply.